Optimum Currency Area for Mainland China and Hong Kong? Empirical Tests

September 2002

Shu-ki Tsang
Hong Kong Baptist University
Hong Kong Institute for Monetary Research

Summary

After the political unification of Hong Kong with Mainland China in 1997, Hong Kong is supposed to function as a separate economic entity under the frameworks of "one country, two systems" and "one country, two currencies". However, increasingly close economic ties, particularly in recent years, have raised the possibility of full integration despite political constraints, and even of monetary union as the Chinese currency progresses towards full convertibility.

This paper employs the theory of optimum currency area (OCA) pioneered by Robert Mundell in 1961. To test whether Mainland China and Hong Kong constitute an OCA, which would provide strong reasons for monetary integration and unification, it adopts the econometric techniques of variance analysis and shocks decomposition over a range of variables including (1) GDP; (2) fixed asset investments; (3) export trade; (4) deposits and loans; and (5) consumer price indexes and stock prices. Regions within an OCA should show small variances and react to shocks in a symmetric manner.

The results presented in this paper point to a picture which is very sceptical of a positive answer. The empirical findings based on disaggregated historical data show some signs of real and nominal convergence (GDP and inflation) only between Hong Kong and some parts of Eastern China, driven by trade. This seems to be consistent with the actual trajectory of economic integration, which was not detected in the previous studies of Liang (1999) and Ma and Tsang (1999). However, all other results, even those based on higher frequency data of consumer and stock prices in the more recent past, fail to provide evidence that Hong Kong and the Mainland as a whole as yet constitute an OCA.